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Notwithstanding his opaque manner, Mr. Greenspan became a cheerleader for financial-market optimism and implicitly ratified the excesses. He failed to take the timely action that would have instilled more caution in investors, believing as he does that markets can work things out on their own. Well, they have.

William Greider, author of *Secrets of the Temple*, writing for the *Washington Post*, Aug. 13, 2002

DISCOVERING THE TRUTH

The present U.S. economic downturn is unique both in its cause and in its pattern. Since it was not caused by monetary tightening, the Fed's aggressive monetary easing has proved ineffective in reviving economic growth. The primary cause of the downturn is an unprecedented depression of profits that, in turn, has precipitated a depression of business capital spending. Associated causes are the carnage on Wall Street, record-high debt levels and credit quality issues, hampering credit availability for businesses.

Recent broad, pronounced weakness in U.S. economic data strongly suggests an aborting recovery. Since the stock market and the dollar responded with rather strong rallies, however, it has been asked whether the two may be bottoming out.

Our guiding query is whether or not the U.S. economy is improving. Basically, it is reeling from three closely related major implosions: *first*, plunging corporate earnings; *second*, plunging corporate capital investment; and *third*, plunging corporate equity values. Among these three features, the profit performance is definitely the governing factor. Amazingly, it finds very little attention. As always, it is the center of attention in this letter.

It can be argued that it will essentially take time to correct and to heal the growth-inhibiting maladjustments that have accumulated in the U.S. economy and its financial system during the preceding boom. That is true, of course. But the quandary in the U.S. case is that any necessary corrections remain completely missing. Above all, the profit outlook is getting darker and darker.

TWO OMINOUS PARALLELS

For the first time in the more than 50 years since World War II, the world is in the grips of a synchronized global economic downturn. This has but one precedent in history: the Great Depression of the 1930s. The most striking common feature of both periods is the dominant role of the U.S. economy in the prior boom as well as in the following downturn.

Yet there exists a conspicuous difference between the two cases of American global economic predominance. During the 1920s, America flooded the world with credit, acting as the world's lender of last resort, while in the 1990s it became the world's consumer of last resort, flooding the world with unprecedented excesses in consumer spending.

Remarkably, the two U.S. boom episodes were alike in their heavy disposition towards consumer spending. However, the borrowing and spending excesses of the 1990s vastly exceeded those of the 1920s. Another difference of crucial importance is in the state of the balance of payments. During the 1920s, America was the world's leading creditor country, running a chronic current surplus. Today, it's the world's greatest debtor, running a monstrous deficit in current account and piling up trillions of foreign debts.

An old bone of contention between American and European economists is at what time the American Federal Reserve made its decisive policy mistakes that determined the protracted depression of the 1930s. Was it the excessive monetary looseness before the stock exchange crash? That is the opinion in Europe, strongly

influenced by Austrian theory. Or was it excessive monetary tightness after the crash, during the 1930s? That is American opinion, as indoctrinated since the 1960s by Milton Friedman.

We are a great believer in the logic of Austrian theory. It says that the severity and length of depressions depends critically on the kind and the magnitude of the maladjustments and dislocations that have developed in the economy and its financial system during the preceding boom.

THE EVIL OF CREDIT EXCESS

It seems to us an exceedingly straightforward logic. Moreover, it has historical experience on its side. Assessing the present economic situation in the United States, the key point to realize is that for years it has been exposed to the most inordinate credit excesses in history. It has been crystal-clear for a long time that it was a typical *bubble economy*, being defined as an economy where unusually sharp rises in asset prices fuel extraordinary borrowing and spending binges, either by businesses (Japan) or by consumers (America).

Established economic theory, by the way, has a strict measure for “excess” credit — all credit in excess of available savings from current income that is not spent for consumption. The essential economic effect of such saving is to release productive resources that a borrower may use for capital investment. Traditionally, the credit cycle has been associated with the investment cycle.

Credit expansion in the last three years in the United States has been running at an annual rate of around $2 trillion, accounting thus for about 20% of GDP. Never mind that combined personal and business savings plunged in 2001 to barely 2% of GDP. The discrepancy between the two defies the wildest imagination of a reasonable economist.

Today’s American policymakers and economists apparently find nothing wrong with this pattern. Least of all do they understand that such a runaway credit expansion could do any damage to the economy and the financial system. Doesn’t it boost economic growth and financial markets? The only serious economic damage they can think of is rising inflation rates, and their absence in the past few years testified in their view to the U.S. economy’s excellent health. Another inherent logic is that this justifies virtually unlimited credit expansion.

We subscribe to the opposite view, which may be called classical European economics, that credit creation in excess of available savings is by itself an evil that tends to harm the economy far more than consumer-price inflation by encouraging reckless spending that essentially distorts the allocation of real resources.

A BADLY SPLIT ECONOMY

Of course, the consumer-spending boom of the last few years in the United States was crucial in propelling the economy’s growth. As a share of GDP, it shot up to an average of 82.6% between 1995–2001, as against a long-term ratio of about two-thirds. But it essentially did so at the expense of saving, capital investment and the balance of payments.

As domestic demand grew persistently in excess of domestic output, the deficit in the current account ballooned from $139.8 billion in 1998 to $417.4 billion, running lately even at an annual rate of $450 billion. A large part, if not the greater part, of the rapidly swelling consumption demand was actually met by foreign producers possessing the necessary idle capacities. Since the early 1980s, the nation has moved from a net creditor position of 13% of GDP to a net debtor position of 25%. Altogether, this adds up to almost 40% of GDP.

The inevitable domestic result has been a badly split economy. The part exclusively serving the consumer and also being sheltered from foreign competition boomed with strong profit growth, while the sectors that serve capital investments and are also exposed to foreign competition have been badly withering with collapsing profits.

The most striking feature and testimony of this split in the economy is an extreme divergence in the profit performance of two sectors — manufacturing and retail trade. In 1997, manufacturing earned $195.5 billion,

comparing with retail trade earnings of $63.9 billion. After five years, this relationship has been turned completely on its head. In the first quarter of 2002, manufacturing profits had slumped to $68.9 billion, while retail trade profits were up to $81.4 billion, both figures at annual rate.

It should be self-evident that this dramatic diversion in profitability between the two sectors had far-reaching implications for their investment policies. While the profitable retail trade sector has grossly overinvested in relation to sustainable consumer demand, the unprofitable manufacturing sector has just as grossly underinvested in plant and equipment. This is the kind of structural distortions that Austrian theory emphasizes as the recession-breeding consequence of major credit excesses.

Assessing the U.S. economy's prospects, this big split between consumer-related and investment-related activity is, certainly, of greatest relevance. Considering furthermore that it has developed over years, it cannot be discarded as cyclical. Clearly, the overall poor profit and capital spending performance is structural. And with the economy's slowdown it has dramatically worsened.

For the same reasons, there is clearly no chance under these circumstances for business investment to lead an economic recovery. This would have to come almost single-handedly from the consumer. But for that to happen, he must do more than keep spending at a high level. To lead a recovery, consumer spending has to rise by 3–4%. But in reality, in the second quarter it was down to an annual rate of 1.9%. Before long, he will altogether capitulate.

In the end, all questions about the U.S. economy boil down to one, whether or not business investment will return with sufficient vigor. But for that to happen, it needs both a luring profit outlook and accommodating financial markets. Neither is in sight. Though monetary policy could hardly be looser, the financial markets are nevertheless tightening up against business financing, and consumer financing is sure to be next.

RAVAGED BALANCE SHEETS

As a matter of fact, we are looking out for financial turmoil in the United States of a gravity without precedence in the whole postwar period. Our main consideration in this respect is the balance sheets of businesses and private households that have been recklessly devastated in the past few years.

Saying this, we also explicitly think of 1930. Back then, businesses went into the Depression with balance sheets that they had strengthened with record-high stock issues during the boom, taking advantage of the cheapness of equity capital. To quote Joseph Schumpeter: American business "eventually entered the Great Depression with a financial outfit which was nothing short of luxurious."

In the 1990s, American businesses chose with vehemence to do the exact opposite. In order to comply with the Wall Street request of maximizing stock prices in the short run, they leveraged their balance sheets with the recklessness of desperados who have everything to gain in the short run and nothing to lose in the long run.

One measure, widely applied with mergers, acquisitions and stock buybacks, was to simply substitute debt for equity. As credit was far more expensive than equity, this plainly depressed profits. But the trick was to dupe investors by shrinking the number of outstanding shares, inherently increasing profits per single share, the measure on which market attention effectively focuses. Though it was a plain case of systematic deception, everybody liked it because it apparently helped to lift share prices.

There was no lack of other and even greater economic and financial follies. Considering rising stock prices as the key test of corporate performance, mergers and acquisitions became the hallmark and centerpiece of the new corporate growth strategies. For some mysterious reason, it became the compelling rule for mergers and acquisitions that the acquiring firms had to pay a large premium over the prevailing market price of the stock that, in turn, happened to vastly exceed the acquired book values.

The essential results were yawning gaps in balance sheets between the astronomic prices paid for acquired

companies and their book values. It was a matter of simple bookkeeping to fill the gap with a piece of paper titled "goodwill." The justification was that it reflected the big synergy gains that these companies would reap from their acquisitions in the future.

Typically, these coveted synergy effects were mainly expected from cost cuts eulogized by the catchwords *downsizing*, *restructuring*, *outsourcing*, *laying off employees*, *limiting benefits* and *buying back stock*. The words *capital investment* and *capital formation* are strangely lacking in the vocabulary describing these strategies.

A PHONY GROWTH MODEL

The traditional way for businesses to expand is organic growth through capital investment. What unites the new measures that became prevalent in American corporate governance during the past several years were two particular strands. It was overwhelming emphasis on cost-cutting and quick moneymaking in the financial markets, in contrast to new capital investment.

The decisive underlying idea was that these measures were prone to inflate stock prices faster and to higher levels than the slow capital investment strategies of the past. The tremendous impact of the developing deal frenzy is shown in the fact that it peaked in 2000 at $1.8 trillion for that year alone. For most people, the booming stock market was compelling proof that these promises and expectations were perfectly valid.

On the surface, looking at the following explosion of stock prices, it, indeed, worked splendidly for five or six years. Understandably, this was readily, too readily, attributed to the profit and productivity miracles that America's new equity culture was supposed to deliver.

Strikingly, the stock market's splendor not only blinded the public but also policymakers and economists to the fact that the new corporate strategies in conjunction with the ludicrous money and credit excesses that Mr. Greenspan delivered had other major effects, gravely ravaging the economy's health. We hasten to add that, from a macroeconomic perspective, these adverse effects were perfectly predictable. These easily verifiable effects were:

- ***First, a very ill-structured pattern of economic growth, heavily skewed towards consumption with collapsing personal saving;***

- ***Second, very ill-structured corporate balance sheets, heavily skewed on the assets' side towards worthless "goodwill," as against record-low net investment, and exorbitant debt growth on the liabilities' side;***

- ***Third, the most miserable profit performance of the whole postwar period. Not only has corporate America failed to keep its promises of higher profits, but what it actually delivered was the worst profit performance in the whole postwar period.***

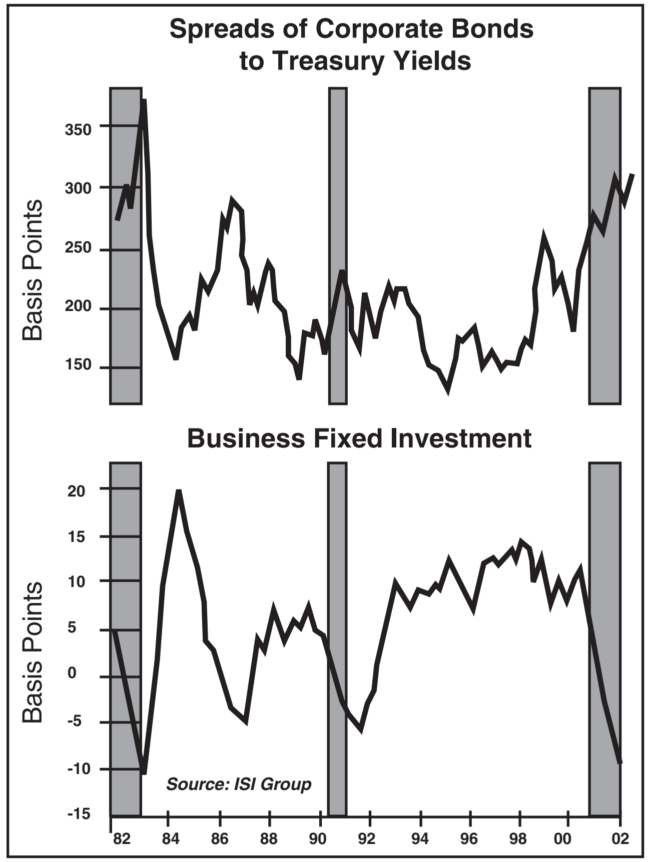
BALANCE SHEET RECESSION

For an economic recovery to materialize, two prerequisites are indispensable: a favorable profit outlook and ample availability of new finance. Sliding profits have been the obvious, primary cause of the crisis in business capital spending in the United States, which, in turn, has been driving the U.S. economy's downturn.

But there are increasing signs that in addition to the profit slide a second major depressing effect on the economy is developing: declining credit availability for businesses. In other words, there is a credit crunch for businesses in the making, and lately it appears to be worsening dramatically. Since investment spending is highly credit dependent, this essentially implies still lower investment.

The reason is obvious: dwindling corporate creditworthiness due to the prolonged, very poor profit performance and badly ravaged, highly fragile balance sheets. Frightened rating agencies, criticized for not seeing through accounting frauds, are more aggressively reviewing and downgrading companies.

Consider that the spread of Ford's 7.25% 2011 bonds has risen to more than 400 basis points over Treasuries. For a similar bond of General Motors, the spread is more than 300 points over Treasuries. Not so long ago, these were blue chip companies. In other words, the corporate bond market is tightening.



Or putting it differently, the Fed's interest lever has become irrelevant for corporations borrowing mainly in the bond market. What difference would it make to the economy if the Fed's rate were 1%, rather than the present 1.75%? None. It would please the stock market for one or two days. That's all. Just look at how stimulatory zero interest rates are in Japan.

LESS AND LESS GDP FOR MORE AND MORE DEBT

Actually, we keep pondering the very same question about the current money and credit creation. It keeps running at record pace. Yet far from stimulating the stock market, as in the past, it has failed to prevent its prolonged steep decline. Obviously, the former strong linkage between money growth and the financial markets has broken down.

Historically, the relationship between debt growth and economic activity, as measured by gross national product or domestic product, has shown remarkable stability. Since borrowed money is usually spent on newly produced goods or services, this is hardly astonishing. During the first three decades after World War II until the late 1970s, this debt-to-GDP ratio hovered around 1.40-to-1. For each dollar added to GDP, 1.40 were added to nonfinancial debt.

The departure from this pattern began in the 1980s. Sharply accelerating credit growth delivered proportionately less GDP growth. But it was in the late 1990s that this ratio accelerated to an unusually high pace.

During 1997–2001, U.S. GDP in current dollars grew overall by $1,764 billion. Over the same period, non-federal debt grew by $4,557 billion. That is, there was $2.60 in additional debt for each dollar added to GDP.

In 2001, the aggregate indebtedness of non-federal borrowers rose by $1,109 billion while GDP grew only by $258 billion. This boosted the debt-to-income ratio to the unprecedented level of 4.3-to-1. For each dollar added to GDP, 4.30 were added to debt.

Not included in these numbers are the simultaneously exploding debts of the financial sector. Taking these, too, into account, the debt-to-income ratio for the same period comes to 4.8-to-1. On top of this domestic credit creation comes, of course, the soaring foreign lending through capital inflows. The safest thing to say is that this debt ratio is absolutely unsustainable.

CHANGING USE OF CREDIT

First of all, we greatly doubt that credit will continue to be as abundantly available in a recession as in the past several years of economic hype. But with the escalating debt service in mind, we wonder also about the causes and implications of the disruption in the relationship between credit growth and economic activity.

On reflection, one realizes that this must essentially derive from a major change in the use of credit in the United States. It is a grossly neglected fact in economics that the effects of credit and money creation are not

simply a question of quantity, but that they crucially depend on the purposes of the credit creation.

The point to see is that a drastic shift has taken place in the United States over the past few years in the use of credit for expenditures that do not add to GDP growth. A most striking and also most obvious case has been the soaring U.S. current-account deficit. The money that buys the import surplus comes largely from current, domestic income, and partly from credit creation. In order to offset this domestic demand contraction, running presently at well over $400 annually, it needs compensating credit creation just to prevent economic contraction.

But the most sweeping change in the use of credit has definitely occurred on the part of businesses. In the past, businesses borrowed mainly to finance capital investment in excess of depreciations and rising inventories. All this went fully into GDP growth. Since actual and potential capital investment was limited in quantity, this put a natural limit on borrowing requirements.

That changed dramatically with the shift towards mergers and acquisitions. In the absence of any limit to buying other firms, the sky became the limit for potential corporate borrowing. It soared as never before. Within the six boom years between 1995–2001, business debt jumped by $2.8 trillion, or a stunning 69%.

But its proceeds went overwhelmingly for the corporate merger, acquisition and stock buyback mania, that is, for the purchase of outstanding equity securities. Obviously, the debt and credit creation that finances this kind of spending adds nothing to GDP growth.

THE KEY FAILURE: NET INVESTMENT AT RECORD LOW

We are coming to the key failure of the Wall Street model for economic growth. Over the past few years, we have persistently warned that this merger and acquisition mania must essentially lead to a neglect of new capital investment. If buying new capacity is so easy and also exercised so quickly, why should a company bother to build new factories, which takes years to accomplish? In fact, net new business capital investment almost disappeared.

Even today there remains a widespread perception that America's New Economy was built on an unusually strong investment boom. It rests largely on the familiar statistical illusion that the hedonic pricing of computers causes in the calculation of real GDP growth. Yet even in nominal GDP, America's ratio of business investment in the past few years has been the highest in the postwar period.

But there is a snag. Because investment has increasingly shifted into short-lived assets with high rates of depreciation, a growing share of capital spending only replaces plant and equipment that wears out. In essence, this barely expands production. Depreciations on the capital stock, by the way, add nothing to incomes. Nevertheless, conventional GDP treats them in full as capital spending.

Measuring capital formation and capacity growth, net investment is, therefore, the far better guide. As a rule, gross and net figures move in lockstep, but the changes in the U.S. investment pattern towards short-lived assets have been of a scale that has thoroughly altered the relationship. Few people seem to realize that this has also played an important role in depressing profits, because rising depreciations means rising expenses.

During the years 1995–2001, gross nonresidential fixed investment, measured in current dollars, increased $376.5 billion, or 7.6% per annum. But of this amount, $311.5 billion went through depreciations for the replacement of worn-out machinery. Net investment spending on nonresidential plant and equipment (that is, gross investment net of depreciations) grew during the same six years only from $203 billion in 1995 to $268 billion in 2001, after peaking in 2000 at $407 billion.

With a miserable increase in net investment by $65 billion, or $11 billion per annum, this represented America's lowest net investment ratio in history, except for the Great Depression in 1930–33. And remember that business debts rose in these years by $2.8 trillion.

THE DEBT TRAP

Pondering the causes that disrupted the former link between credit growth and GDP growth, there is yet another mechanism at work that we regard as the most dangerous part of the American debt machine. It is the rapidly accelerating compounding of interest. The root of the trouble is that interest is charged not only on the principal but also on the accumulating unpaid interest. Consider that a 7% credit increases in this way by 41% within five years, and more than doubles within 10 years.

We think a most troubling part of the economic and financial development in the United States is that the soaring debt loads incurred during the past several years, not only by the consumer but also by businesses, were used almost in full for unproductive purposes. It is the kind of borrowing that relentlessly leads into the famous debt trap.

In the euphoric climate of the past few years, a rapidly growing part of the record-high credit expansion in the United States accrued, without question, from the mechanical addition of unpaid interest to the principal. Incidentally, this also prevents the appearance of bad loans. They habitually surface rather late when the lenders stop this automatic interest financing and instead request payment in cash. Then, only then, the incurred indebtedness begins to hurt both the borrowers and the economy. Large imbalances that were easily financed in the euphoria of the boom all of a sudden become infinancible in times of economic weakness.

In the view of Mr. Greenspan and the bullish consensus, the runaway credit expansion of the past few years was justifiable and sustainable because it led to massive wealth creation in the asset markets while America's inflation rates remained subdued. But unfortunately, this kind of wealth creation in the financial markets, in contrast to the wealth creation in the economy through building factories, involves no additions to incomes. Rather, it has boosted consumer spending at the expense of such productive wealth creation.

The collapse of net investment is, of course, the inferential counterpart to the sharp rise of consumption as a share of GDP. Many American economists apparently regard consumption as the chief engine of economic growth with cumulative effects on investment. But in a fully employed economy, higher consumption is not a mechanism to stimulate investment but one to choke it off.

PERCEPTION VERSUS REALITY

The great surprise of the past few months has been the worsening carnage on Wall Street, affecting virtually every nation in the world. In terms of absolute amounts of wealth destruction, it is already by far the worst bear market in history. Professionals and amateurs are stunned. Yet considering the scale of financial savagery, there appears to be a remarkable absence of alarm or even worry.

Presumably this has its reason largely in the widespread acceptance of the popular spin that the U.S. economy as a whole is fundamentally in much better shape than the accounting scandals seem to indicate. Implicit to this view is the comforting conclusion that once the government displays sufficient determination for reform, everything will be fine again.

Our impression of the relationship between prevailing perception and reality in this respect is the exact opposite. While everybody keeps imploring the economy's "fundamental" health and strength, we keep wondering what they are referring to. Profit implosion, a collapse of savings and capital investment, an outsized trade deficit and badly ravaged balance sheets, all this does not seem to matter for the U.S. economy's health in the eyes of American policymakers and most economists. Unlike customary early indicators and consumer surveys, all these strange and rare items in economic history don't fit into the familiar pattern of recession and recovery. So they ignore them.

What this carnage on Wall Street is beginning to reflect is definitely not misguided market psychology but the terribly bad shape of the U.S. economy, as strikingly reflected in the disastrous development of capital formation, savings and profits. These three are the key determinants of healthy economic growth in the long run. But in the past few years in the United States all three have been devastated as never before.

As for the stock market, the surprising thing for us is not its accelerating fall but that stock valuations remain so ludicrously overpriced, due to the obvious fact that profits have been falling faster than stock prices.

RECOVERY MYTH

At issue are, strictly speaking, two questions about the U.S. economy. The one is about the effective start of a sustained recovery, and the other one is about the economy's longer-term growth prospects.

Until the Commerce Department published its benchmark revisions for GDP and profits in late July, the bullish consensus community raved about the mildest recession in history with just one quarter of contraction. Policymakers haughtily expressed their doubts that there was a recession.

Nothing encouraged the prevailing optimism about the U.S. economy's health and strength more than the news of a 6% rebound of real GDP in 2002's first quarter. True, this was a stellar number, but its anomalous pattern ought to have caused early misgivings. Reflecting mainly a slower liquidation of inventories and a spurt in government spending, it lacked any similarity with the typical pattern of a beginning economic recovery.

In like vein, it was strikingly evident that several temporary factors had acted as a booster rocket for the economy in the quarter, among them the mildest winter in U.S. history, the greatest surge in cash-out mortgage refinancing ever and a strong post Sept. 11 bounce-back effect as most economic activities returned to normal after the routing of the Taliban.

Also, we keep wondering how many people are acutely aware that these quarterly GDP numbers in the United States are a statistical fiction, due to the established practice to annualize them, implying that quarterly figures are multiplied by four. Effectively, it was 1.24% for the first quarter and 0.26% for the second quarter. We doubt that these numbers would have caused any excitement.

It is generally hoped that the spendthrift consumer will sustain overall demand until rising business capital investment kicks in. The latest data show the exact opposite development on both counts. Consumer spending has slowed sharply during the second quarter, while business investment spending, after its worst plunge in the whole postwar period, fails to show any hint of a meaningful rebound.

New economic data over the last two months have been overwhelmingly negative. New orders for manufactured durable goods for July were a rare exception. Yet unfilled orders for manufactured goods increased merely 0.3%, following a June decrease by 1.6%. New factory orders declined in June at a 2.4% rate, of which non-defense capital goods orders fell by a staggering 9.1%, the weakest performance in seven months. Orders for consumer durables fell 4.1%. June construction spending was reported down 2.2% against the prior month and 3.7% compared to a year ago. Non-residential capital spending is 20.1% below its level a year ago, of which industrial building fell almost 46%.

Next to surprise with very bad news was the Institute of Supply Management about manufacturing activity. Expected for June was an index of 55, after 56.2 in May. But the actual outcome was 50.5, suggesting a barely growing industrial sector. A reading below 50 implies contraction in the sector. The key new orders component sank 10.4% to 50.4.

Consumers and housing have been the mainstay for overall demand. But consumer spending sharply slowed in the second quarter to 1.9% at annualized rate after 3.1% in the prior quarter. Residential construction spending has now declined for three consecutive months. June's year over year increase of 3.9% compared with May's 7.4%.

While the consumer's spending has remained highly resilient, his sentiment indexes are spelling very bad surprises. Month for month the declines substantially exceed expectations. Within two months, the index of the Conference Board has plunged from 106.4 in June to 93.4 in August.

A particularly bad surprise was the news that business payrolls had expanded by only 6,000 workers in July, as against the expected 66,000. Generally unnoticed went the fact that total hours worked fell 0.3%

All in all, these uniformly weak numbers allow no thought of a sustained U.S. economic recovery. Typically, it starts with a bang. In the past U.S. recoveries since World War II, real GDP growth has averaged almost 11%

during the first eight quarters; that is, more than 5% per year. Assuming 3% potential economic growth, such a recovery rate is necessary to increase capacity utilization.

FAREWELL NEW ECONOMY

Yet by far the worst part of the recent spate of bad news about the U.S. economy came with the "benchmark revision" of the national income and product accounts that the Commerce Department published in late July, covering the development of GDP, incomes and profits over the years 1999–2001. Effectively, it demolished any remnants of the New Economy.

First of all, the numbers show that the recession in 2001 was real. The script of a one-quarter blip has been rewritten as a three-quarter downturn. According to the pre-revision data, real U.S. GDP during the first three quarters of 2002, including the quarterly dip, had increased by $6.5 billion. The benchmark revision turned this into a decrease of $57.2 billion, accounting for a cut in GDP growth by 0.9 percentage points.

Most remarkable and most ominous, however, are not the changes in the rate of aggregate GDP growth, but the dramatically different response of consumer spending and business capital spending. Plainly, the recession was more than accounted for by a virtual collapse of business capital spending. It fell during the three recession quarters by $88.2 billion, and during the full year, measured from fourth quarter to fourth quarter, by $123.5 billion. This compares with an increase in consumer spending by $175.2 billion.

It is now widely recognized that a self-sustaining recovery of the U.S. economy depends crucially on a radical reversal in business capital spending. But for that to happen, it needs a reasonable profit outlook.

AN UNPRECEDENTED PROFIT DISASTER

Far from showing any improvement in profits, the Commerce Department's benchmark revisions have put the final nail into the coffin of America's New Economy by a further drastic, retrospective downward revision of profits. Still more bizarre is the fact that this slaughter of past profits has found zero attention. The revision slashed profits before tax from current production for 1999 by $19.4 billion, for 2000 by $88.3 billion and for 2001 by $35.5 billion. The main losers were nonfinancial corporations.

Actually, these cuts in profits follow downward revisions of similar size a year ago. Please keep in mind, these are the profits calculated by the government statisticians within their national income and product accounts. Their primary source, the IRS tabulations of corporate tax return, become available with a lag of one year and more. What these downward revisions of profits mainly reflect is that actual corporate tax payments during these years have drastically lagged earlier tax estimates.

We have persistently been emphasizing Corporate America's poor profits performance, as measured by the government's national income and product accounts, contrasting preposterously with the propaganda of a profit miracle as trumpeted by Wall Street, Mr. Greenspan and firms.

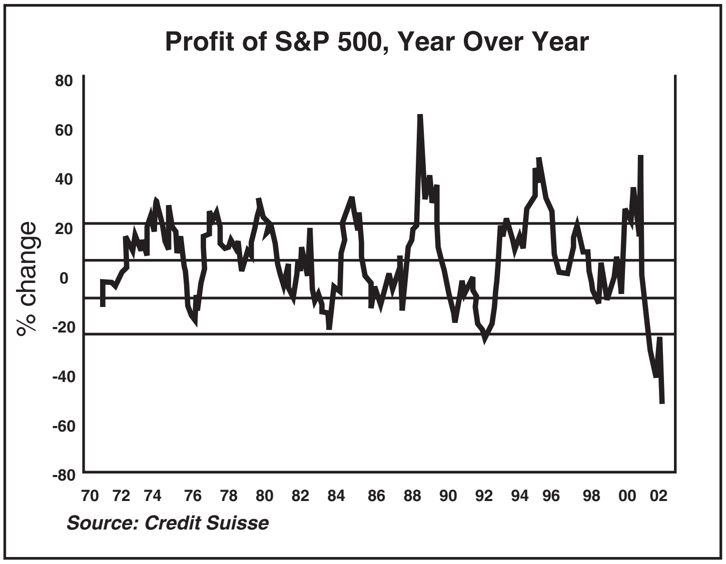
As the following table shows, the profits crisis really started as early as 1997. For a still booming economy, the profit performance in the following years was amazingly weak even by the originally reported numbers, let alone in comparison with the prevailing profits hype. Taking the benchmark revisions of 2001 and 2002 into account, the poor profits expose an outright profits disaster.

U.S. DOWNWARD REVISIONS OF PROFITS OF NONFINANCIAL SECTOR (IN $ BILLION)

	1997	1998	1999	2000	2001	2002
ORIGINAL NUMBERS	504.5	506.8	530.4	577.9	371.4	291.1
BENCHMARK REVISION 2000	504.5	478.8	467.8	491.8	371.4	
BENCHMARK REVISION 2001	504.5	478.8	455.9	423.0	333.7	

Source: Department of Commerce, Survey of Current Business

It was an outstandingly miserable profit performance from two perspectives: First, the profits decline started at the height of the boom in 1997; and second, its slide in the wake of the economy's slowdown is unusually steep. For the few observers keeping track of these official income and profit figures, the trumpeted profit miracle was always pure fiction and a sham, disguising an unusually poor profit performance. What finally emerges is the worst profit performance of the U.S. economy in the whole postwar period.



Considering that profits govern the economic growth of capitalistic economies, it keeps amazing us how little attention this profits disaster actually finds. If it endures, it essentially spells protracted Japanese-style economic near-stagnation.

Looking for more details, we discovered some further shocking facts. Overall, profits in the nonfinancial sector fell from 1997 to the first quarter of 2002 by 42%. This compares with GDP growth over the same period by 23%. In other words, as a share of GDP and national income, profits have literally collapsed. Apparently related to the economy's slowdown, the profit decline sharply accelerated from the second quarter of 2000.

Pondering the causes of this unusually savage profit squeeze, we took a look at commensurate experience in past business cycles and discovered that the ups and downs of profits were strictly correlated with the ups and downs of interest rates imposed by the Fed. Between 1979–82, during Paul Volcker's fierce monetary tightening, with the federal funds rate temporarily up to almost 20%, overall business profits fell from $270 billion to $195 billion. But the Fed-induced rise in the interest bill from $144 billion to $256 billion accounted for substantially more than that.

The present savage profit squeeze is unique in history in that it has occurred in the absence of any rate hikes on the part of the Federal Reserve. In fact, it slashed its interest rates with unprecedented speed.

Yet soaring interest expenses are playing a key role in ravaging profits. For the business sector as a whole, business interest expenses soared between 1997–2001 for the nonfinancial sector by 65%, and for manufacturing by 81%. And most remarkably, they continued to rise in 2001, despite the Fed's aggressive rate cuts.

Clearly, this is structural. What it reflects hardly needs explanation. It's the debt-driven merger, acquisition and stock buyback mania on the one hand and plunging net investment on the other. Again, we want to emphasize that this protracted interest-related profit squeeze is no surprise. It is the perfectly predictable, implicit longer-term outcome of the strategies applied in the name of maximizing shareholder value.

THE KEY TO PROSPERITY: CAPITAL FORMATION

It used to be a truism among generations of economists that the industrial nations overwhelmingly owe their great wealth and the fantastic rise in their living standard to three things: saving, capital investment and technological progress.

Of course, the new industrial technologies played the key role. But what really turned them into the sweeping economic success that materialized was the associated, tremendous capital formation through high rates of saving and investment. Nobody looked at the stock market as a source or a measure of wealth creation. It was understood that this must essentially occur in the factories.

The fact is that technological innovation as such is no relevant part in the process of economic growth and

wealth creation. Relevant is the associated capital formation creating in its process employment, incomes and tangible wealth. But in order to realize the gigantic capital formation inherent to the industrial revolution, it also required sufficiently high savings rates making the necessary real resources for the high rate of capital investment available. Under these conditions a high rate of productivity was, rightly, taken for granted.

This was the concept that dominated economic policies and corporate strategies at the time, and it worked splendidly because the applied microeconomic strategies conformed to sound macroeconomics.

What happened during the last few years in the United States was in essence the exact opposite of the pattern that distinguished the implementation of the industrial technology. How the promised profit and productivity miracles would come about was always left unexplained. Strikingly, saving and capital formation enjoyed complete disregard. Rising stock prices were everything. There was a complete blackout of macroeconomic thinking. Yet it enraptured the whole world. Foreigners poured trillions of dollars into the U.S. economy in order to participate in the promised miracles.

A new book, *Buy, Lie and Sell High: How Investors Lost out on Enron and the Internet Bubble*, by Harvard Business School Professor D. Quinn Mills, argues that the '90s bubble was not due to "irrational exuberance" by individual investors, but to a complete ethical collapse by American banks, brokers and the Fed.

We couldn't agree more. But this collapse of ethics was more consequence than cause. The all-important question in this context rather is the precipitating cause behind this sudden, epidemic outbreak of corporate profit fraudulence. It hasn't come just by accident. The obvious, common motivation was a common desire to hide the generally disasterous profit performance. That is the key point to recognize.

It might be argued that overambitious profit goals, set by the companies themselves, were the mistake. What had to be camouflaged is, unfortunately, far worse than that. The profits that America's new equity culture actually delivered were not only considerably lower than promised. They are, effectively, the lowest in the whole postwar period, measured as a share of national income.

Earlier we enumerated the reasons that are mainly responsible for this profit misery: on the asset side the accumulation of too much worthless goodwill derived from grossly overpaid, purchased shares and too little productive net capital investment, and on the liabilities' side from exploding debts. That such blatant macroeconomic nonsense could be sold to the world for years as a magical cure for productivity and profits is hard to understand.

Yet in general it has apparently still to be realized that those measures serving to boost stock prices were inexorably prone to depress profits in the longer run. Many people are now saying that the New Economy was no better than the Old Economy. They are grossly mistaken. It is worse, much worse. The widely applied corporate strategies intrinsically had very destructive effects on the crucial, basic determinants of potential economic growth — savings, capital formation and profits.

RECOVERY A VAIN HOPE

The most urgent question concerning the U.S. economy is the accomplishment of the recovery that the overwhelming consensus has been predicting. Any new economic data are uniformly distinctly negative. Following the minimal 1.1% annualized growth rate for the second quarter, they clearly spell a new downturn. Though a possible or probable double-dip has become the general talk in town, everybody seems to take it in stride, perhaps because there have been others before, followed by sustained recovery.

As we have emphasized earlier, the length and depth of recessions is principally a function of the scale and kind of economic and financial maladjustments that have accumulated in the economy during the boom. There is massive dislocation everywhere: in savings, in capital investment, in the balance sheets of consumers and corporations, in the balance of payments.

Past recoveries were powered by those sectors where the monetary tightening had created "pent-up demand."

These were the interest-sensitive demand components: housing, business equipment, inventories and consumer durables. Real GDP growth during the first eight quarters of recovery averaged more than 10%, or a little over 5% per year.

We are at a complete loss to imagine anything remotely similar for the U.S. economy in the foreseeable future. It is hard to see any pent-up demand. Driven by rising house prices, housing and consumer durables have done precisely the opposite. Business capital investment has been slumping, but arising primarily from the profit carnage, it appears more than doubtful that there is pent-up demand building up. The U.S. economic recovery is a vain hope.

CONCLUSIONS:

America's New Economy, characterized by massive investment into the new information technologies and a new corporate governance culture, guided by the imperative of maximizing shareholder value, was thought to have broken all of the old macro rules and to deliver miracles of profit and productivity growth as far as the eyes can see.

Rampant hype and most rampant money creation catapulted stock prices to ridiculous, stratospheric levels. The dismal reality in the economy, however, was an unprecedented consumer borrowing and spending binge and the worst ever performance in corporate profits, savings and capital investment.

America's monstrous asset bubble has left behind an array of growth-inhibiting structural dislocations — a profit implosion, a record shortfall of saving, a capital spending collapse, a massive current-account deficit and record-high debt levels. Together, they exclude any possibility of a sustained economic recovery.

In fact, the widely trumpeted recovery has aborted even before it started. More than 80% of the annualized real GDP growth rate of 3% in the first half of 2002 has accrued from diminished inventory liquidation and government spending.

There are many things that make this economic downturn different from previous postwar cycles. But the single most dominant influence is the profit implosion. As long as it lasts, it will compel businesses to curtail spending on employment and investment.

Be prepared for an accelerating downturn of the U.S. economy.

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